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July 26, 2006

Re: Transfer of Limited Liability Company Interests to Irrevocable Trusts

Dear Mr. _____,

This letter is in response to your correspondence dated May 22, 2006, addressed to Acting Assistant Chief Counsel Robert Lambert. In that letter, you requested our advice regarding the change in ownership consequences of a proposed transfer of limited liability company (LLC2) interests into a Grantor Retained Annuity Trust (GRAT), an irrevocable trust, or alternatively into an intentionally defective grantor trust (IDGT), which is also an irrevocable trust. Your questions were initially set forth in a letter dated April 21, 2006, that you sent to the

County Assessor. You indicated in your May 22 letter that the _____ County Assessor would not provide an opinion, but "would abide by" a written opinion we provide. You, your colleague _____, and I clarified your questions in two telephone calls on July 12, 2006. For the reasons set forth below, we conclude that:

- (1) Transfers of LLC2 interests must be analyzed under both the "cumulatively more than 50 percent" test of subdivision (d) of section¹ 64 of the Revenue and Taxation Code *and* the "change in control" test of subdivision (c)(1) of section 64. However, if the transfer of LLC2 interests results in a change in control under subdivision (c)(1) of section 64, reappraisal of the property owned by LLC2 will be pursuant to subdivision (c)(1) rather than subdivision (d) of section 64.
- (2) Transfers of your client's LLC2 interests to and from a GRAT would not cause a change in control of LLC2 and are excluded from counting or cumulation for purposes of subdivision (d) of section 64 as long as your client is the trustor and sole present beneficiary of the GRAT.
- (3) Transfers of your client's LLC2 interests to an IDGT for which your client's children are the sole present beneficiaries and remainderpersons would not result in a change in ownership of the property owned by LLC2 unless a change in control under subdivision (c)(1) of section 64 resulted from the transfers. Additionally, depending on whether other interests in LLC2 are transferred, a change in ownership of the property previously excluded from

¹ Unless otherwise indicated, all statutory references are to the Revenue and Taxation Code.

reassessment under subdivision (a)(2) of section 62 could be triggered because your client's transfers would be counted for purposes of subdivision (d) of section 64.

Facts

Your client is a member of LLC2, which owns vacant land in _____ County. LLC2 was formed several years ago by four individuals, each owning a 25 percent interest. LLC2 acquired some land through direct purchase (Acquired Land), and other land (Excluded Land) was acquired from another limited liability company (LLC) in a transfer that was excluded from reassessment under subdivision (a)(2) of section 62.

Under your proposal, two members of LLC2 (A and B) will each transfer a 7.5 percent interest in LLC2 to separate GRATS² (GRAT A and GRAT B). A and B will each be the trustee and sole present beneficiary of his or her respective GRAT, with their children as remainderpersons. Because the land owned by LLC2 is vacant, the annual annuity amount may have to be funded by the transfer of some of the LLC2 interests back to A and/or B.

Alternatively, you propose that your client establish an IDGT for the present benefit of your client's children. Under this alternative, your client would sell an unstated percentage of his or her LLC2 interest to the IDGT in exchange for a promissory note. If the IDGT were terminated for any reason, any LLC2 interests held in the trust at termination would be distributed outright to the children.

Applicable Law

Section 60 provides that a change in ownership occurs upon a transfer of a present interest in real property, including the beneficial use of the real property, with a value substantially equal to the value of the fee interest. A change in ownership includes a transfer of any interest in real property between a legal entity such as an LLC and any shareholder, partner, or any other person (Rev. & Tax. Code, § 61, subd. (j)), unless the transfer is excluded from change in ownership. There is no change in ownership when a transfer is a change solely in the method of holding title to the real property and the proportional ownership interests in each and every piece of real property remain unchanged after the transfer. (Rev. & Tax. Code, § 62, subd. (a)(2)).

Transfers of interests in legal entities generally do not constitute a change in ownership of real property owned by the legal entities. (Rev. & Tax. Code, § 64, subd. (a).) However, when any person or entity obtains direct or indirect control of a legal entity (defined as ownership or

² You explain in your April 21 letter that "[b]y transferring the property (or a portion of the property) to a GRAT, the Trustor can structure the terms of the trust (which is irrevocable) to pay him an annuity, based on the amount of property originally transferred, certain IRS tax tables, and the Trustor's life expectancy. During the term of the GRAT (whether it is for 2 years, 5 years, or 15 years), the Trustor is the income beneficiary of the GRAT and the property is treated, for income tax purposes, as if it had never been transferred at all. In fact, the common practice is that no separate income tax return is filed and that all income is recognized on the Trustor's personal return. Once the GRAT terminates, however, the Trustor's interest in the GRAT terminates and whatever property is left in the GRAT is distributed, pursuant to the terms of the GRAT instrument."

control of more than 50 percent of stock or other ownership interests), a change in ownership of *all* the real property owned by the entity occurs. (Rev. & Tax. Code, § 64, subd. (c)(1).) Additionally, when a transfer of real property to a legal entity is excluded from change in ownership under section 62, subdivision (a)(2), the persons holding ownership interests in the legal entity immediately after the transfer are considered "original co-owners." (Rev. & Tax. Code, § 64, subd. (d).) Whenever shares or other ownership interests representing cumulatively more than 50 percent of the total interests in the legal entity are transferred by any of the original co-owners in one or more transactions, the property previously excluded from change in ownership under section 62, subdivision (a)(2) is reappraised. (Rev. & Tax. Code, § 64, subd. (d).) Subdivision (d) of section 64 provides that:

If property is transferred on or after March 1, 1975, to a legal entity in a transaction excluded from change in ownership by paragraph (2) of subdivision (a) of Section 62, then the persons holding ownership interests in that legal entity immediately after the transfer shall be considered the "original coowners." Whenever shares or other ownership interests representing cumulatively more than 50 percent of the total interests in the entity are transferred by any of the original coowners in one or more transactions, a change in ownership of that real property owned by the legal entity shall have occurred, and the property that was previously excluded from change in ownership under the provisions of paragraph (2) of subdivision (a) of Section 62 shall be reappraised.

The date of reappraisal shall be the date of the transfer of the ownership interest representing individually or cumulatively more than 50 percent of the interests in the entity.

A transfer of shares or other ownership interests that results in a change in control of a corporation, partnership, limited liability company, or any other legal entity is subject to reappraisal as provided in subdivision (c) rather than this subdivision.

Thus, for property previously excluded from reappraisal under subdivision (a)(2) of section 62, *either* the transfer of more than 50 percent of original co-owner interests *or* a change in control will result in a change in ownership of the previously-excluded property. However, if a change in control under subdivision (c)(1) of section 64 occurs as a result of a transfer, the property held by the legal entity will be reappraised under subdivision (c)(1) rather than subdivision (d) of section 64.

A change in ownership does not include a transfer into trust, or back to the trustor, where the trustor or trustor's spouse is the present beneficiary of the trust. (Rev. & Tax. Code, § 62, subd. (d).) Because trusts are not treated as separate legal entities for property tax purposes³ (i.e., we "look through" the trust), the present beneficiary of an irrevocable trust is regarded as the owner of the property held in trust. (See Property Tax Annotation 220.0790.) Subdivision

³ Massachusetts business trusts and similar entities are not considered "trusts." (Cal. Code Regs., tit. 18, § 462.160, subd. (e).)

(b)(1)(C) of Property Tax Rule (Rule)⁴ 462.160, which interprets and explains the statutory provisions related to trusts, provides that a change in ownership does not include:

The transfer of an ownership interest in a legal entity holding an interest in real property by the trustor into a trust in which the trustor-transferor is the sole present beneficiary or to a trust in which the trustor-transferor retains the reversion as defined in subdivision (b)(1)(B) of this rule. However, a change in ownership of the real property held by the legal entity does occur if Revenue and Taxation Code section 61(i), 64(c) or 64(d) applies because the change in ownership laws governing interests in legal entities are applicable regardless of whether such interests are held by a trust.

Rule 462.180, which interprets and clarifies the rules set forth in the Revenue and Taxation Code governing the transfer of real property involving legal entities, provides that, for purposes of determining whether more than 50 percent of an entity's total interests have been transferred, certain transfers are not counted or cumulated for purposes of subdivision (d) of section 64. Subdivision (d)(2) of Rule 462.180 provides that:

For purposes of this subdivision ((d)(2)), interspousal transfers excluded under Section 63 of the Revenue and Taxation Code, transfers into qualifying trusts excluded under Section 62(d) of the Revenue and Taxation Code, and proportional interest transfers excluded under Section 62(a)(2) of the Revenue and Taxation Code shall not be cumulated or counted to determine a change in ownership.

Thus, as provided in subdivision (d)(2) of Rule 462.180, we have previously opined that if a transfer to or from a trust is excluded from change in ownership under subdivision (d) of section 62, then the transfer is not counted or cumulated for purposes of subdivision (d) of section 64. (See Property Tax Annotation 625.0192.) However, transfers of original co-owner interests between parents and children are cumulated or counted because none of the above exclusions applies.⁵ Original co-owner status terminates when the property excluded from reassessment under section 62, subdivision (a)(2) is reappraised or the property is transferred from the legal entity to the individual(s) who hold interests in that legal entity in a transfer excluded from change in ownership under section 62, subdivision (a)(2). (See Property Tax Annotation 220.0452.)

Questions Presented and Analysis⁶

- 1. "It is our understanding of the Revenue and Taxation Code that because of the entity-to-entity transfer (or, 'original co-owner' to 'co-owner' transfer), of which the members of each LLC were the same, owning the same proportionate interest, that**

⁴ All references to Property Tax Rules are references to title 18 of the California Code of Regulations.

⁵ Additionally, the parent-child exclusion does not apply to transfers of legal entity interests. (Rev. & Tax. Code, § 63.1, subd. (c)(8).)

⁶Quoted material is taken from your April 21 letter.

any future transfers of interest in LLC2 will be reviewed under the 'cumulative 50%' rule under Revenue and Taxation Code section 64(d), rather than the 'change in control of more than 50%' rule under Revenue and Taxation Code section 64(c)(1). Do you agree with our analysis that we should be looking at R&T Code § 64(d) when reviewing this transaction? If not, would you agree that it is actually R&T Code § 64(c)(1) that we should be applying (which is the code section we would prefer)?"

Response: For the Excluded Land, both change in ownership tests must be considered. The owners of LLC2 became "original co-owners" when the Excluded Land was transferred to LLC2. The county assessor must analyze all subsequent transfers of interests in LLC2 under both the "cumulatively more than 50 percent" test of section 64, subdivision (d) and the change in control test of section 64, subdivision (c)(1) to determine whether a change in ownership of the Excluded Land occurs. Assuming that the Acquired Land was reappraised upon its purchase, the county assessor must analyze only the change in control provisions of section 64, subdivision (c)(1) to determine whether a change in ownership occurs. Consider the following examples (in which A, B, C and D are each 25 percent owners, and original co-owners, of LLC2):

Example A. *C transfers his 25 percent to "F," and D transfers his 25 percent to "G" and B transfers a one percent interest to "H."* More than 50 percent of original co-owner interests have been transferred but no one individual or entity obtains control of LLC2. The Excluded Land previously excluded from change in ownership under 62, subdivision (a)(2) would be reappraised, and the original co-owner taint with respect to LLC2 interests would disappear. The Acquired Land would not undergo a change in ownership.

Example B. *C transfers his 25 percent to A and B transfers one percent to A.* Less than 50 percent of the original co-owner interests have been transferred, but A has acquired 51 percent of LLC2. Under section 64, subdivision (c)(1), both the Acquired Land and the Excluded Land undergo a 100 percent change in ownership due to the change in control of LLC2.

Example C. *C transfers his 25 percent to A, D transfers his 25 percent to "H," and B transfers his one percent to A.* Both the "cumulatively more than 50 percent" and the "change in control" tests have been met. Under section 64, subdivision (d), the change in control provision of section 64, subdivision (c)(1) takes precedence. Therefore, both the Acquired Land and the Excluded Land undergo a 100 percent change in ownership.

- 2. Is there a change in ownership when LLC2 interests are transferred to and from the GRAT? How are LLC2 interest transfers to and from the GRAT counted for purposes of determining whether the "cumulatively more than 50 percent" requirement of subdivision (d) of section 64 is met? For example, where "I" represents your client:**

I transfer a 30% [interest in LLC2] (of which I am a 50% owner) to a seven-year GRAT, which is required to pay me \$100,000 a year for seven years. In the fourth year of the GRAT, there is insufficient income to pay me the \$100,000 annuity; so instead, the GRAT makes a distribution to me of a 2% interest in [LLC2], which in year four, equals the \$100,000 annuity payment.

In year six, again, the GRAT has insufficient income and makes a distribution to me of a 3% (the amount that equals \$100,000 in that year) interest in [LLC2]. So, that when the GRAT terminates at the end of the following year, there is only 25% of [LLC2] left to distribute to the beneficiaries named in the GRAT instrument.

Response: In this example you present, there is no change in ownership because your client remains the sole present beneficiary of the irrevocable trust to which he transfers his LLC2 interests. Under section 62, subdivision (d)(1), the transfer of the 30 percent interest in LLC2 to the GRAT is not a change in ownership because it is a transfer to a trust of which the trustor is the sole present beneficiary. Likewise, the transfers of two percent and three percent of LLC2 interests you are not counted, as transfers from such a trust back to the trustor are also excluded under section 62, subdivision (d).

As explained in Property Tax Annotation 625.0192, the exclusion from the counting or cumulation requirement of subdivision (d)(2) of Rule 462.180 applies to all transfers that are excluded from change in ownership under subdivision (d) of section 62. Thus, as long as your client is the trustor and sole present beneficiary of the GRAT you describe, interests in LLC2 may be transferred to and from the GRAT without a change in ownership and without the transfers being counting or cumulated for purposes of section 64, subdivision (d).

3. On termination of the GRAT, what percentage of the LLC would be considered "transferred" for change in ownership purposes? How would this be counted for purposes of subdivision (d) of section 64?

Response: Only the interests held by the GRAT on the termination date would be transferred to the children; therefore, only those interests would be considered for change in ownership purposes. In your example, 25 percent of LLC2 would be transferred (i.e., 30 percent was initially transferred to the GRAT, but five percent was returned to the trustor). Because a transfer from a parent to a child is not excluded from counting or cumulation under subdivision (d)(2) of Rule 462.180, the transfers to the children on termination of the GRAT would be counted and cumulated for purposes of section 64, subdivision (d).

4. "As an alternative to the GRAT contemplated above, we are also considering having our client sell a percentage of his LLC2 interest to an IDGT in exchange for a promissory note. All income generated by the trust assets (the LLC2 interest) would remain taxable to the grantor during the term of the trust. It is our understanding that as long as the transaction does not otherwise violate Revenue and Taxation Code section 64, that a transfer to an IDGT is a non-transfer for property tax purposes. Please confirm that this would be your understanding of a transfer to an IDGT."

Response: The trustor's children are the present beneficiaries of the irrevocable trust and are therefore considered to be the beneficial owners of the LLC2 interests when they are transferred into the trust. (See Property Tax Annotation 220.0761.) Under this alternative, the transfer of LLC2 interests could trigger a change in ownership of the Acquired Land and Excluded Land

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under section 64, subdivision (c)(1), if the transfer would result in any person or entity obtaining control of LLC2. Also, because transfers between parents and children are not excluded from counting or cumulation under subdivision (d)(2) Rule 462.180, a change in ownership of the Excluded Land could result if these transfers, cumulated with other counted transfers, exceed 50 percent of the interests in LLC2 transferred by original co-owners. However, regardless of whether the transfers *into* the trust result in a change in ownership, any subsequent transfers of LLC2 interests from the IDGT outright to the children are not considered transfers of a beneficial interest in the LLC2 interests, because the children are the present beneficial owners of the LLC2 interests, whether the interests are held in trust or directly by the children. Therefore, the transfer of LLC2 interests from the IDGT to the children would not be counted or cumulated for purposes of section 64, subdivision (d) and therefore, would not be counted or cumulated for purposes of section 64, subdivision (d).

The views expressed in this letter are only advisory in nature. They represent the analysis of the Board staff based on present law and the facts set forth herein. Therefore, they are not binding on any person or public entity.

Sincerely,

/s/ Carole Ruwart

Carole Ruwart
Senior Tax Counsel

CR:eb
Prec/Legal Entities/06/277.cr

cc: Honorable
County Assessor

Mr. David Gau, MIC:63
Mr. Dean Kinnee, MIC:64
Ms. Mickie Stuckey, MIC:62
Mr. Todd Gilman, MIC:70